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Tuesday, May 13, 2008

Ben Bernanke plays John Law

John Law and the Mississippi Bubble are fairly well-known to economic historians, but one wonders whether the supposed economic experts who run the U.S. Federal Reserve remember it.

To briefly summarize (and necessarily oversimply), Law was an economist and gambler put in charge of the French central bank in the early 18th century. The bank issued notes (i.e. paper money) backed primarily reserves of, not gold or silver, nor French sovereign debt, but of stock in the Mississippi Company, which owned huge tracks of recently acquired, but hardly settled, American frontier land. In other words, the currency was backed by speculative real estate ventures. After a few good years, the scheme quickly collapsed in hyperinflation and bankruptcy.

Fast forward to today. The Federal Reserve has traditionally used as reserves, on top of some gold, U.S. federal debt (Treasuries), considered a "risk free" investment (actually they are by market measures of risk generally the *lowest* risk, but not risk-free, as anyone holding Treasuries during periods of dollar inflation can attest to). Quite recently, however, this has changed:

What has replaced Treasuries in the Fed's hoard? Here's how Randy Waldman puts it:

The difference, about $475B, represents an investment by the central bank in risky assets of the US financial sector.

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Nick Szabo

"A premier thinker about history, law and economics, and the lessons they have for security." -- Adam Shostack, Emergent Chaos

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In other words, the Fed has been replacing the lowest-risk asset, U.S. Treasuries, with assets considered such high risks that trading has often practically halted on them, i.e. the securitized forms of U.S. real estate debt incurred by people who now, we are finding, often cannot or do not pay off their loans. The Federal Reserve is now backing the dollar with securities that have been found to be full of moral hazard.

The Fed does have a tool for eliminating most of this debt problem: inflation. If the Fed can flood the economy with enough dollars, presumably enough of these will reach debtors that they will be able to continue paying their mortgages. By investing in shaky debt, Fed has given itself a huge incentive to further inflate the dollar. It has given itself further incentive to fleece holders of dollar liabilities, including investors in dollar-denominated debt, in order to bail out the real estate market.

We have seen a massive runup in commodity prices during the the same period during which real estate debt has replaced Treasuries in the Fed's portfolio. The dollar has already fallen steeply, and people ranging from retirement funds to second- and third-tie consumers of commodities are hedging against a quite possible further collapse of the dollar. Commodity producers are betting against the dollar by keeping commodities in the ground instead of ramping up production, and food is being stockpiled in every poor country where the

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currency is linked to the dollar. As I recently wrote:

> The dichotomy [most economic commentators have made] between a presumably inefficient "bubble" caused by "speculation" and fundamental (geological and technological) scarcity presents a false choice.
>
> The more likely alternative is that the parallel price rises of practically all commodities (not just oil) are a rational and socially efficient response to the inflation (M3 etc.) of the dollar and to a lesser extent of the euro. The vast increase in "non-commercial" or "speculative" participation in commodity futures reflects a greatly increased use of commodities over the last 5 years for their monetary qualities, just as Carl Menger and others would predict. See Commodity Derivatives: the New Currencies and The "Hoarding" and "Speculation" in Commodities.

Posted by Nick Szabo at 11:55 AM

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